Joint Committee on Boards, Commissions and Consumer Protection

<u>$200 MILLION IN TAXES OR $200 MILLION IN LOANS?:</u>

CROSS-CUTTING ISSUE FOR ALL BOARDS UNDER THE DEPARTMENT OF CONSUMER AFFAIRS

2005

In 2002/03 and 2003/04, a number of boards under the Department of Consumer Affairs (DCA) loaned the General Fund millions of dollars from their reserves. Those loans were reflected in the sunset reports they filed with the Committee for 2004. However, in the boards' budget projections over the next three fiscal years only one board forecast repayment of the loans. When questioned about this, virtually every board up for review reported that they did not expect repayment in the next several years.

Because loans could hinder board consumer protection programs or cause fees paid by licensees to remain higher than necessary, the Chair of the Committee has requested an in-depth and candid assessment of these loans as the sole "Cross-Cutting" issue for this sunset review cycle.

Committee staff has found evidence and legal authorities suggesting that there are serious questions about whether these fund transfers are genuinely – and lawfully – loans.

Because these loans can jeopardize board operations essential to public safety, they raise serious policy questions.

Finally, as revealed below, whether technically legal or not, whether wise public policy or no, honesty requires that the Committee must scrutinize the current record to determine whether these loans are what they have been called, or if they are, in fact, functionally the same as taxes. A candid assessment of the highly unusual circumstances surrounding these loans so far impels the conclusion that the 2003-2004 budget approved by the incumbent Governor and the 2002-2003 budget approved by the prior Governor raised millions of dollars from what are functionally taxes imposed on tens of thousands of professional businesspeople throughout California; most of them working in or owning small businesses.

I. First Principles: The Professional Boards Within The DCA Exist To Protect Consumers.

The chief function of the boards and commissions ("boards") in the DCA is to "promote and protect the interests of California consumers." (http://www.dca.ca.gov/aboutdca/morabout.htm) (See also Bus. & Prof. Code section 101.6: "The boards, bureaus, and commissions in the department are established for the purpose of ensuring that those private businesses and professions deemed to engage in activities which have a potential impact upon the public health, safety, and welfare are adequately regulated in order to protect the people of California.")

Where the regulation of California's licensed professions is concerned, there are a number of ways the boards within the DCA "promote and protect" the interests of consumers:

- Licensing of professionals assures a minimal level of competence among the licensees.

- By providing consumers information that permits them to choose knowledgeably between licensees on the bases of such factors as education, experience, and record of discipline, boards promote a more vigorous and rational marketplace that rewards licensee quality and conscientiousness.

- The most important consumer protection function of a board is enforcement. Both consumers and properly licensed professionals expect that the boards will be able to identify and discipline those licensees who fail to adhere to minimum standards of competence and integrity. Most basically, such enforcement is required to protect individual consumers from being harmed, either physically, where the healing arts professions are concerned, or economically, where the other professions are concerned. Discipline meted out by a board is an incentive for a potentially wayward licensee to remain competent and trustworthy. Revocation or suspension of a license is a way to, in effect, eliminate the ability of one licensee to harm consumers in the future.

But the importance of a vigorous and publicly credible enforcement program extends beyond protecting individual consumers from individual licensees. Just as those who manufacture food or drug products enormously benefit when the public has a high degree of confidence that such products are safe (in such cases, consumers freely spend their money), the entire community of licensees financially benefit when consumers have confidence that a license in California assures certain minimum levels of competence and honesty.

II. Brief Summary Of How Board Enforcement Programs Work, Why They Cost Money, And Why The Public And The Profession Lose When Boards Try To Do Enforcement "On The Cheap."

Boards receive information about potentially troubled licensees from a variety of sources, including consumers who complain to the board, insurance companies who may be required to report malpractice pay-outs to the board, or peers. (See, for e.g., Bus & Prof. Code sections 801, 805)

Complaints must be processed by salaried board staff to see whether, at minimum, the complaint is of the kind that falls within the board's legal jurisdiction; in other words, could constitute legal grounds for discipline. Preliminary fact-checking and gathering is also done at this stage.

If warranted, a complaint is then referred to an investigator. These peace officer investigators are either salaried employees of the board or salaried employees of DCA, in which case the board must reimburse DCA for their time.

If, after an investigation, it is determined that a complaint should proceed to a formal disciplinary proceeding, the board transfers the file to a Deputy Attorney General for the filing and prosecution of such a legal action. Just as many other legal clients, the board must pay its "law firm" (here, the Office of the Attorney General) for the time spent by its lawyers. The hourly rate charged by the Attorney General is $135.00 an hour.

As this brief summary illustrates, and to borrow Jesse Unruh's well-known phrase, money is the mother's milk of vigorous and reasoned board enforcement. The more money a board has, the more complaints it can investigate, the more effectively it can investigate them, the faster it can investigate them, the faster a threat to consumer confidence in the profession can be addressed, and the faster any potentially unjust cloud hanging over a licensee can be cleared. The more money a board has, the less it needs to fear large bills from the Attorney General's office incurred in pursuing cases against litigious licensees.

And the more resources a board has, the more it has the capability to identify and punish misconduct by truly bad-apple licensees. A board less flush will instead be forced to rely on potentially over-inclusive but inexpensive-to-investigate-and-prosecute cases. For example, the 2002 sunset review of the Medical Board revealed that its enforcement program filed a disproportionate number of unprofessional conduct actions "piggy backing" on criminal drunk driving or small drug possession (e.g., marijuana) convictions or pleas while relatively de-emphasizing gross negligence complaints leading to death or serious injury.[1]

IN SUM: For all of these reasons, both the public and the community of licensed professionals benefit from a reasoned and thorough enforcement program that is not forced to do the important job of enforcement without adequate resources. Professionals benefit by not worrying about arbitrary enforcement based less on competence or integrity than on a smaller price tag. Consumers benefit by the greater likelihood that licensed professionals who truly pose a danger to the public will be identified and disciplined.

III. A Board Has Obligations To Licensees As Well.

As mentioned above, the chief aim of the DCA and its boards, mandated in statute, is consumer protection. But, of course, licensees deserve consideration too, beyond the financial benefits they derive from public confidence in their profession as a result of regulation. Each and every professional board is almost entirely funded by license fees and virtually no General Fund moneys support their programs. License fees are deposited into so-called "special funds." These funds are designated as "special" because they are not to be mingled with the "general" fund. (See, e.g., B&P sections 2980 (Psychology Fund); 4974 (Acupuncture Fund); 4996.6 (Behavioral Science Examiners Fund); 8030 (Court Reporters Fund) Even though these moneys are in "special" funds, appropriations from these funds still must be made via the normal budget process.

Mandatory license fees are akin to taxes in one respect: they are obligatory payments imposed on citizens to fund a government enterprise. For this reason, while fees must be at a level high enough so that the board can carry out its functions effectively and appropriately, license fees should be no higher than necessary to support a board's legal obligations, including an enforcement program that promptly deals with complaints, is professional, and generally has the resources to do the job in a way worthy of the professional's and public's trust.

IV. The Budget Balancing Tactic Of Requiring Boards To "Loan" Money To The General Fund Either Hinders Effective Board Enforcement Or Keeps Fees Artificially High.

In its September, 2004 report, the LAO estimates next year's General Fund shortfall will be about $6 billion in 2005-06. However, a recent report in the *Los Angeles Times* says that administration officials believe the shortfall for 2005-06 may amount to $8 billion.

[1] A resource-strapped Medical Board struggling with long delays in complaint processing was likely hoping that there was a correlation between such relatively quick and inexpensive-to-investigate-and-litigate offenses and the competence or honesty of the professional charged. However, and of course, there may be no such correlation at all. Given the random nature of who is stopped by the police for many DUIs, a brilliant surgeon could end up with a DUI on New Year's Eve, while the incompetent– but equally drunk – colleague behind him drives on by. (For these reasons, SB 1950 (Figueroa) requires the Medical Board to prioritize cases of patient harm first.)

(Halper & Warren, "State May Face Bigger Budget Gap," Dec. 16, 2004) Over the last three years, the State has confronted similarly deep General Fund shortfalls. To avoid raising taxes or cutting essential safety-net and educational programs in response to those shortfalls, the Governor and the Legislature have previously shown a high level of creativity in filling budget gaps.

One of these creations – loans from the special funds to the General Fund – directly affects the statutory dictate of DCA boards to protect the public and their obligation to keep fees as low as practicable.

A. <u>How much and from which</u>.

In Fiscal Years 2002/03 and 2003/04, the General Fund borrowed over $200 million from nineteen board special funds (including five of the boards up for sunset review this year):

Board	Amount Loaned 2002-03	Amount Loaned 2003-04
Barbering and Cosmetology Fund	9,000,000	
Bureau of Automotive Repair	100,000,000	14,000,000
Accountancy Fund	6,000,000	270,000
Behavioral Science Examiners Fund	6,000,000	
State Dentistry Fund	5,000,000	5,000,000
Psychology Fund	5,000,000	
Osteopathic Medical Board of California Contingency Fund	2,700,000	
Pharmacy Board Contingent Fund	6,000,000	
Registered Nursing Fund	12,000,000	
Structural Pest Control Fund	2,000,000	
Private Security Services Fund		4,000,000
Court Reporter's Fund		1,250,000
California Board of Architectural Examiners Fund		1,800,000
California Board of Architectural Examiners -- Landscape Architects Fund		1,225,000
Acupuncture Fund		1,500,000
Contractor's State License Fund	11,000,000	8,700,000
Occupational Therapy Fund		1,000,000
Vocational Nurse Examiners Fund		2,000,000
Vocation Nurse and Psychiatric Technicians Examiners Fund		1,000,000
TOTAL	164,700,000	41,745,000

In general, the money was borrowed from boards that had reserves in excess of the DCA's general rule that boards should hold in reserve adequate funds to operate for between 3-6 months, with an outside limit of 24 months (B&P section 128.5). For example, at the time of its loan, the Court Reporters Board had a surplus far in excess of this rule, with 34 months in reserve; at the time of its loan, the Board of Psychology had a reserve of about 19 months. (After the loan, its reserve level was reduced to about 3.7 months.)

B. <u>Which is still owed what.</u>

As of July 30, 2004, the Department of Finance reported that it had repaid only one of the loans, to the Contractors State License Board (CSLB). After the funds were removed from the CSLB's special fund, the CSLB argued to the Department of Finance that its reserves were dangerously close to being depleted. In 2003, the initial loan of $11 million was repaid. However, that same year the General Fund then took out an *additional* $8.7 million loan from the same board, and repaid *that* amount the following year.

Other than that single instance no other board has been repaid, or appears to anticipate being repaid in the near future.

C. <u>How the loans were borrowed.</u>

Committee staff has contacted the boards due to sunset in 2005 and inquired about the nature of the loans.[2] What staff learned was:

- Boards were not free to say "no" to the loans.

- None of the boards was asked to loan the money -- they were told about it. Some only found out about the loans after the money was transferred.

- There are no loan documents or formal written agreements. There is no promise as to when the loans will be repaid.

- There is barely a promise as to the condition of repayment.

- The only condition is that Department of Finance has promised to repay the money (and must repay it with interest) if and when the board "needs" it; but what that means and who determines it is unclear – and in the interim, interest is allegedly accruing.

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[2] In addition to the material directly provided to the Committee by the boards under review this year, committee staff have spoken with various boards and their Executive Officers, the State Contractor's License Board, the Medical Board of California, and others. Staff have also consulted with Legislative Counsel, and the legislative budget committees, staff of the legislative Judiciary Committees.

For example, the Board of Psychology reports that it has been advised that, only if "need arises" would the Board be permitted to obtain repayment of the borrowed funds. (*Psychology Board's Supplemental Responses to Sunset Review Questions*, p. 3) However, another Board has privately reported to the Committee that its Executive Officer had been told nothing at all about loan repayment, and was under the impression that the borrowed funds were simply gone forever, and would not be returned.

Indeed, some boards whose funds were loaned report that they were unaware that they were loaning the General Fund money until after the fact. Thus, in response to questions from the Committee, the Board of Psychology writes that it "was not consulted at any level or at any time regarding the $5 million loan to the General Fund taken from the Psychology Fund." (*Psychology Board's Supplemental Responses to Sunset Review Questions*, p. 3) Similarly, the Board of Behavioral Sciences reports of its $6 million loan, "At the time the loan to the General Fund was made, Board staff was not consulted in any way prior to the funds being transferred and there was no documentation completed. We did not know the exact loan amount until it appeared in the Governor's Budget." (*Board of Behavioral Sciences Response to Questions from Sunset Review Report*, p. 3).

D. <u>Real World Consequences: Either Enforcement Takes Too Long Or Fees That Are Too High Endure.</u>

As noted above, the amounts loaned to the General Fund were mostly taken from those special funds that had a high level of reserves. For example, and as also noted above, the Court Reporters Board had reserves far in excess of even the maximum amount recommended in statute.

One of the key questions this raises is what the boards could or should have done with those reserves absent the loans, and – more directly – what they will do when and if the loans are repaid.

There are, roughly, two options boards have in such cases. They can spend the money to increase their services or they can reduce their fees charged to licensees.

Even the most efficient boards could benefit from greater staff resources spent on complaint investigations. According to its current Sunset Report, the Board of Behavioral Sciences, for example, spends an average of 675 days, to process, investigate and litigate its cases. This is down from 679 days in 2002/03, which was itself down from 819 days in 2001/02. Of the 675 days, 56 are spent, on average, processing the complaint, and 326 are spent on investigation. The Board of Psychology, in its Sunset Report this year, says that it spent an average of 938 days, which is up considerably from the prior year, where the board spent 810 days, on average.

In both cases, there are many sound reasons for the length of time spent to process and investigate cases properly. But it is equally true that additional personnel devoted to these tasks would bring those numbers down considerably – or allow the board to do more, or more thorough, investigations -- with the obvious consequent benefits to both the public and to the licensees working every day under a cloud of having their license revoked or impaired; their livelihood and investments destroyed.

More fundamentally, how can a board plan on doing anything at all with a surplus if it does not know whether that surplus, and how much of it, will be loaned to the General Fund until the General Fund has already borrowed it?

The second option – reducing fees – is not merely hypothetical. In one example, the loans to the General Fund have already cost thousands of licensed professionals in the state $125 each. The Board of Psychology had regulations pending at the time of these loans that would have reduced its biennial renewal fees to licensees from $400 to $275. This was appropriate because the level of the reserves in the Psychology Fund was well over 20 months. However, when the Board learned that its reserves were to be "loaned" to the General Fund, the fee reduction regulations were withdrawn, and fees to the licensees remained at $400. (See OAL File # Z-02-0311-05, Notice of fee reduction regulations published on March 22, 2002, and regulations withdrawn on September 13, 2002) They continue at that level today.

It is true that, in the main, Department of Finance did not borrow funds from boards that could not afford them, in the sense that the State only borrowed from those funds with large reserves relative to their operating costs. But, this proves too much.

In at least some instances, boards report that their surplus accumulated not because fees were too high to fund an appropriate program, but because the state's hiring freeze – strangely extending even to specially funded boards – and post-hiring freeze rejections of Personnel Year or budget change proposal requests, prevented boards from filling recently vacant positions. Fee levels stayed the same even when staff left or retired and the Governor decreed they could not be replaced. This is at least partly how the surpluses that were borrowed were created; by Executive Branch fiat over boards whose funds – in and of themselves – have no relationship to the General Fund deficit, except insofar as driving up surpluses makes those surpluses available to be borrowed.[3]

V. <u>The Loans Are Of Questionable Legality.</u>

There are statutory, constitutional, and case law restrictions imposed on the "loans." As will be seen, serious questions exist about their lawfulness; questions that will become more serious if the General Fund once again imposes involuntary and after-the-fact "loans" on any special-funded boards in 2005.

A. <u>Statutory Authority.</u>

Pursuant to Government Code section 16320(a)(1), loans between accounts in the State Treasury may be made if two conditions are met: the loans must be "authorized," and

[3] See, Issue #6, Osteopathic Medical Board *Background Paper* for a revealing and more detailed discussion on this point.

"the terms and conditions of the loan, including an interest rate, are set forth in the loan authorization." (Gov. Code sec. 16320 (a)(1), (2))

Committee staff assumes that the (a)(1) requirement of "authorization" is met by the loans being legislatively approved as a part of the budget.

Subdivision (a)(2) requires "terms and conditions." As mentioned above, Committee staff have been unable to ascertain the existence of any documentation at all containing any "terms or conditions" of any of these loans (other than the amounts set out in the budget bill), and no Board contacted (specifically, those subject to current sunset review, as well as the State Contractors License Board) has been able to provide any such documentation. Each board has stated that they were verbally told the loans would be repaid if "needed" with no elaboration on what that means or who determines "need."

Under (b)(1) of the statute, the Director of Finance is to order repayment of all or a portion of the loans if the Department of Finance – **the borrower of the funds** -- determines that either "(A) the fund or account from which the loan was made has a need for the moneys" or "(B) There is no longer a need for the moneys in the fund or account that received the loan." [Here, that would be the General Fund] (Gov. Code sec. 16320 (b)(1)).

A key question, then, is "what is need?"

1. "<u>Need" of a board to avoid insolvency?</u>

As mentioned above, the boards have all been at least orally informed of a single condition under which repayment would be able to occur – "need." That is also the only generally phrased term or condition from the statute concerning repayment for any of these loans.

"Need" is not defined either in the statute or in the informal communications between the loaning board and the "borrower."

The most obvious way to determine whether a board "needs" repayment of its loan is whether the board risks insolvency, financial distress, or an imprudent reserve without it.

The boards under review this year have been asked by the Committee to project their budgets out over the next three years. Virtually all of the boards that had funds "loaned" to the General Fund project that their accounts will remain stable into the future without receiving any amount of loan repayment. For example, even though the Board of Behavioral Sciences loaned the General Fund $6 million in 2002/03, it projects that, with no fee adjustments anticipated, its fund condition will increase from the current 7.7 months in reserve to a possibly over-prudent 14.2 months in reserve by FY 07-08.

Consequently, if the only benchmark for "need" is solvency or something similar, no board is currently forecasting such a need in the foreseeable future. This is fairly consistent across all the boards under review this year that have made loans.

But simple "insolvency" or something similar cannot be the standard for determining "need."

The borrower here has ample power over the boards to prevent them from ever "needing" repayment, if "need" is solely defined as avoiding insolvency or something similar. The boards are considered part of the State's DCA, which is, in turn, part of the State and Consumer Services Agency, which is part of the Executive Branch of state government answerable to the Governor.

The DCA has statutory authority over all regulations proposed by its boards and commissions. (Bus.& Prof. Code sec. 313.1 (d)) Any fee increases – or reductions – must be approved by DCA in such regulations.

Executive branch power over the boards is not limited to DCA itself. Notwithstanding the "special" status of their funds, spending by the boards is always subject to approval by the Department of Finance. The Department of Finance is also part of the Executive Branch of state government answerable to the Governor. In addition, the Director has ultimate authority for actual implementation of the budget through his or her ability to approve any changes to expenditures made by the boards in the Department of Consumer Affairs through the normal process of Budget Change Proposals. Hence, for these reasons, no board can actually spend any of its money without the approval of the Department of Finance.

Therefore, both DCA and the Department of Finance can exercise significant control over any proposed board action that might lead it to create a "need" for loan repayment. A board – either alone or at the instruction of DCA or Finance -- could fail to fill ongoing staff vacancies, cut back programs, tolerate longer enforcement delays, and take other measures that would keep its reserves adequate, but hinder an enforcement program worthy of the public's trust. Or a board (with the approval of DCA) could keep raising fees to the extent it is permitted by law to do so, all to prevent a board from reaching a level of financial distress that might prompt the borrower actually to have to repay the loans.

This helps to illustrate a critical and idiosyncratic fact about the nature of these loan transactions that makes them unlike any loan transaction one would likely see in the private sector. In effect, these loans involve the Executive Branch borrowing money from parties that are fully subordinate to the Executive Branch. Hence, if the solitary stated condition for repayment – "need" -- is anything akin to insolvency or financial distress, it is possible that the borrower could prevent having ever to repay the loan by preventing such a dire "need" from ever arising in the first place.

This relationship between the borrower and the lender here also explains the lack of notice or even perceived need that the boards would be *entitled* to notice when these loans were initially implemented.

Moreover, and as mentioned previously, what likely caused the surpluses that were taken was at least in some cases a hiring freeze and subsequent BCP rejections imposed by the borrower. Even though a vacant position in a specially funded board by definition has no impact on the General Fund, the previous hiring freeze extended to these boards as well. Fees set at a level to fund a fully staffed operation were instead funding significantly smaller staffs, and ever-increasing surpluses.

All these peculiarities illustrate both the power that the administration has over the boards, but also shows how this authority can be exercised solely to ensure that the boards run up surpluses that may then be borrowed year after year.

For all these many reasons, if "need" is based, even in part, upon benchmarks like possible insolvency or precarious reserving**, the only way a board could guarantee that it would qualify for repayment on the basis of its "need" is *both* to try and act in a fiscally irresponsible manner *and* to do so in a way that would escape the oversight of the borrower.**

Hence, if "need" is limited only to "avoiding board insolvency," or something similar, these "loans" are lawful under the statute, but raise other legal issues (discussed momentarily) because they functionally could become permanent transfers.

2. "Need" of the General Fund?

Can "need" as used in the statute instead mean the "need" of the General Fund? Yes and no. Recall, under the controlling statute, there are two independent grounds for repayment, and under the second, it appears that the Director of the Department of Finance would be required to order repayment if the General Fund itself – as the fund that received the money -- no longer "needed" it. (Gov. Code sec. 16320 (b)(1)(B)). So, theoretically "yes" because the statute says this.

But, the answer must practically be "no." In this case it is impossible for the borrower no longer to "need" the money, since the "need" arose in the year the money was loaned, and the money has already been spent to finance the deficit. Thus, there will never be a time when this already spent money is no longer "needed."

On its face, when this second statutory provision is applied to loans used to in-fill General Fund deficits the provision is rendered absurd; it is not a condition of repayment, it is instead transformed into a guarantee that repayment under the statute will never occur.

This condition can be looked at somewhat more broadly, however, if the text of the statute is supplemented with a concept that seems inherent but is not stated. In the event the General Fund is ever in surplus in the future, the state does not have a "need" to continue carrying the debt it owes, and will then pay it back. This contravenes the literal reading of the statute – not to mention common sense -- and defies any sort of ordinary rules applying to borrowers and lenders. It is, however, the only potential meaning this provision can have that makes any sense whatsoever.

But how long will that be? For the next fiscal year, estimates are already appearing that the State will begin its budget discussion with a $6 to 8 billion structural deficit and a vow by the Governor not to raise any taxes. This follows a year in which the state borrowed $15 billion to address its existing budget deficit. And the measure approved by the voters approving the $15 billion was accompanied by a measure prohibiting any future borrowing.

Whatever the political realities and practicalities of state budgeting, the relevant point for the present discussion is that it does not appear likely that this broader reading of section 16320 (b)(1)(B) is anywhere on the horizon.

3. "Need" of a board to fund its programs adequately.

In light of all of the reasons just discussed, the only credible interpretation of "need" that provides even a fig leaf allowing these loans to be considered loans is if "need" is defined as the "need" of the board to run a program in compliance with the spirit and letter of the law.

B. Non-Statutory Authorities.

1. Are the loans illegal transfers?

Given the problematic nature of the determination of "need," as well as the inherent conflicts in the roles of the lenders and the borrower in this situation, it is very possible that these loans could be characterized as not truly being loans. Looked at that way, they would be subject to challenge as illegal transfers.

Outright transfers of money from special funds to the General Fund are flatly illegal. This question was litigated in the early 1990s. One of those cases, *California Medical Association v. Hayes*, illustrates the point.

During the early 1990s the state faced one of its recurring fiscal crises, and attempted to take money from the contingent fund of the Medical Board. Like the funds at issue in the current situation, the Medical Board's contingent fund was (and is) comprised only of fees assessed on licensees for regulatory purposes. Yet the state tried to transfer approximately $2.5 million from the Contingent Fund of the Medical Board to the General Fund, using a variety of accounting methods.

The California Medical Association sued on behalf of its member physicians and prevailed in a Superior Court action. The court ordered the state to stop the transfers from the special fund to the General Fund, and ordered the state to repay any funds it had taken. (See Memorandum and Order dated Feb. 22, 1994, *CMA v. Hayes,* Sacramento Superior Court Case No. 374372) The court ruled that the special fund was a "trust-like" instrument for the protection of the public, and fees paid into it could not be used for General Fund purposes (*Id.* at p. 16). In such a case, "To apply those fees and the interest therefrom to the General Fund would violate the special law prohibition of the California Constitution because such a redirection of funds would arbitrarily require physicians and other users of Medical Board services to pay more in general taxes than other persons." (*Id.* at p. 17)

Unlike *CMA v. Hayes*, the state here is not purporting to "take" the money from the special funds, but only to "borrow" it. If this transfer is truly a bona fide loan, the distinction holds. But, the less these loans look and function like real loans, the more they are vulnerable to legal challenge. At some point, they could very well be held to be tantamount to the transfers held illegal in the CMA case.

2. **<u>Do the loans violate trust principles?</u>**

The public trust theory used in the *CMA v. Hayes* case is based on a legal doctrine dating back to the 1930s. That doctrine recognizes the special funds as being held in "trust" for the benefit of the public and the licensees. At issue in the case of *Daugherty v. Riley* (1934) 1 Cal.2d 298 (*Daugherty*) was the lawfulness of three "legislative manipulations" that "skeletonize[d] the [department] of corporations financially, at the same time leaving the extensive duties and responsibilities of that department otherwise unaffected." (*Id*. at 304)

As with the boards here, the Department of Corporations in *Daugherty* got its "sole support" through "revenue from fees and permits" from licensees. The department's "substantial" reserve was not challenged as being inappropriate. (*Id.* at 303)

The first legislative "manipulation" occurred in 1929. In the 1929 Act, the Legislature appropriated $300,000 of the department's $752,000 reserve to pay for the construction of an office building. The department would be headquartered in the new building, but the building would house other state tenants that by the terms of the Act would be required to pay rent to the department. (*Id*. at 304)

The second "manipulation" occurred in 1931, when the State appropriated an additional $210,000 from the department to complete the construction. *(Ibid)*

The third "manipulation" was a statute enacted in 1933 that repealed the provision that rents from the building would be paid to the department. Instead, they would be paid to the state. (*Ibid*.)

The Commissioner of Corporations sued the state, alleging that the laws were unconstitutional "special taxes" violating Article IV and "double taxation" violating Article XIII (a different provision than today's Proposition 13).

While expressing skepticism about the Legislature's motives, the Court nevertheless held the 1929 Act to be constitutional because, on its face, the statute required the rents from the new building's tenants to be paid to the department. According to the Court, it was "subsequent acts of the legislature in failing to safeguard the investment of this special fund for the benefit of the department" – meaning, the subsequent repeal of the department being the recipient of the rents – that constituted the "fatal infirmity." (*Id*. at 308)

In comparison, the 1931 Act did not, for example, require that rents be paid to the department in exchange for the second appropriation of the department's special funds and thus did not have "the earmarks of an appropriation for the benefit of the [department] of corporations." (*Ibid*.)

The Court held that the department's fee generated "revenues are in the nature of a trust fund raised for a particular purpose … they are not state revenues in the sense that they may be used for any state purpose so long as the department is not in need of them [.]" (*Id*. at 308)

Citing a litany of cases addressing special funds for nurses, dentists, the regulation of railroads, and real estate, the Court reasoned:

> "That these special funds are raised for regulatory purposes and are set apart for the exclusive use of the state departments and agencies for which they are imposed and collected cannot be doubted. That these funds may not be permanently diverted from their specific purposes and to such an extent as to render the department or agency unable to function is likewise clear. This is especially true in the present case where the legislature has established elaborate governmental machinery the effective operation of which is essential to the transaction of business depending on its proper functioning. It would appear to be self-evident that the legislature may not on the one hand set up a department to authorize, regulate and supervise business transactions large and small, imposing fees upon those affected for the purpose of carrying out the purposes of the law, and on the other hand permanently divert the funds thus raised and constituting the life blood of the department to a general fund or other general tax purpose."

(*Id.* at 309)

The Court next addressed the chief argument of the Legislature's and the Governor's; namely, that since the Legislature had the "power to create" the special funds, it has the power to "destroy" them, unless there is a vested right at stake. The Court did not appear to confront that question directly, reasoning that even if the Legislature and the Governor had such power, the measure would nevertheless violate the then-constitutional ban on so-called "special" taxes. (*Id.* at 310)

The Court then ordered the State to repay the department all funds appropriated under the authority of the 1931 Act, an amount of $186,609.21. (*Ibid*.)

Importantly, the Court distinguished what the Legislature did in 1931 – which it characterized as "boldly [taking]" the money – from a loan which, presumably, would pass muster. Indeed, on this score, the Court emphasized that its ruling "did not deny power on the part of the legislature to transfer a special fund reserve temporarily," but, to be lawful, they must be repaid "as soon as funds are available." (*Id.* at p. 309)

It is unclear in an era of ongoing structural General Fund shortfalls what "available" means.

Moreover, the Court cited "statutory authority for impressing a trust … on the corporation commission fund." Then-Political Code section 453a simply provided that moneys paid into the "state treasury which have been collected or received for a specific purpose" are special fund moneys. That statute is similar to the statutes creating special funds for the DCA boards and commissions. (See, e.g., B&P sec. 2980 (Psychology Fund); 4974 (Acupuncture Fund); 4996.6 (Behavioral Science Examiners Fund); 8030 (Court Reporters Fund)

It is unclear from the Supreme Court's reasoning whether the existence of the statute was essential to its conclusion, or was just another reason impelling it beyond application of freestanding common law trust principles. It thus may be that the "trust" character of the DCA board's special funds is indeed solely a creature of statute and therefore could at least prospectively be destroyed by another statute, whether enacted in the Budget Act or distinctly.

This appears to be the teaching of *Urban v. Riley* (1942) 21 Cal.2d 232, 235. In *Urban*, the state would every year transfer any leftover balances in the Real Estate Fund to the General Fund. The Real Estate Commissioner sued to stop this practice and to have the transferred moneys returned, relying upon *Daugherty*.

The Supreme Court rejected the claim. The Court distinguished *Daugherty* by observing that the statute creating the Real Estate Fund expressly contemplated that leftover annual balances would be transferred to the General Fund. In contrast, the statutes creating the special fund in *Daugherty* established that it was "permanently set apart … for the use of the department." (*Id*. at 235, quoting *Daugherty*)

So, it is likely that the extent of the trust imposed will be adjudged by the terms of the statute creating the trust. It may be, then, that the Governor and the Legislature could destroy the "special" nature of these funds – and their trust-like character – by a new statute. How and whether this reasoning would allow the Governor and the Legislature to alter the trust character of a special fund retrospectively, to reach fees previously collected under the terms of a prior trust-creating statute, is unclear. It is difficult to imagine a court following either the *Daugherty* or *Urban* courts permitting such a retrospective amendment, however.

Indeed, if such retrospective changes in a trust-creating statute were permissible under trust principles, then the change in the law that the *Daugherty* Court held to be in violation of those principles – changing who received the rents, for example – would have been upheld.

3. <u>Are the "loans" constitutional under Prop. 13?</u>

These loans raise not only trust issues, but have constitutional implications. Specifically, the constitutional question has to do with whether the money collected by the boards and loaned to the General Fund is functionally a fee or a tax.

In June 1978, California voters added article XIII A, commonly known as the Jarvis-Gann Property Tax Initiative or simply "Proposition 13" (article XIII A), to the state Constitution. The initiative's purpose was to assure effective real property tax relief by means of an "interlocking 'package' " consisting of a real property tax rate limitation (art. XIII A, § 1), a real property assessment limitation (art. XIII A, § 2), a restriction on state taxes (art. XIII A, § 3), and a restriction on local taxes (art. XIII A, § 4). (*Amador Valley Joint Union High Sch. Dist*. v. *State Bd. of Equalization* (1978) 22 Cal. 3d 208)

Section 3 of article XIII A restricts the enactment of changes in state taxes, as follows:

> "From and after the effective date of this article, any changes in State taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members . . . of the Legislature, except that no new ad valorem taxes on real property, or sales or transaction taxes on the sales of real property may be imposed."

Proposition 13, however, allows the State to impose fees on regulated industries without having to comply with the two-thirds vote requirement to raise taxes. There is, though, an important conceptual difference between fees and taxes that prohibits the State from using its majority-vote power to impose regulatory fees to make an end-run around the two-thirds vote requirement provisions of Proposition 13 for taxes.

In *Sinclair Paint v. Board of Equalization* (1997) 15 Cal.4th 866, the California Supreme Court examined the difference between regulatory fees and taxes, and reaffirmed its rule that in order to be considered fees and not taxes, regulatory fees must (1) not exceed the reasonable cost of providing services necessary to the activity for which the fee is charged; and (2) may not be levied for unrelated revenue purposes. (quoting *Pennell v. City of San Jose* (1986) 42 Cal.3rd 365, 375)

License fees are not considered "taxes," then, for one key constitutional reason – they are assessed on a specific, identifiable group, and are available solely for uses directly related to regulation of the very licensees who pay them. "Taxes," by contrast, are available for any General Fund purpose at all – they are entirely fungible funds. (See *City and County of San Francisco v. Farrell* (1982) 32 Cal.3d 47, 57; Gov. Code sec. 50076)

If regulatory fees are used for any purpose ***other than regulating the very profession from whose licensees the funds came, those fees have been transformed into general taxes***, and, quite literally, the licensees have been subjected to a tax not imposed on other citizens, all without debate as to whether such an imposition is fair, the best revenue-raising option, or sound public policy.

As *Sinclair* makes clear, simply calling something a fee does not make it a fee; the distinction is judged functionally. Diction is not determinative.

If Gov. Code section 16320 (b)(1)(B)'s requirement that repayment of loans is not required until the borrower no longer "needs" the money is read literally, such that there will never be a need for the already-spent money and repayment is therefore never required by statute, licensees likely have a claim under *Sinclair* that they have paid a tax, not a fee. The State might defend against such a claim by arguing that the Legislature's vote on the budget is a 2/3 vote, and thus that Proposition 13's requirement has been met.

That defense might prevail. It is true that the fees assessed by a board are assessed pursuant to statute and statutes can be altered by the Legislature and the Governor in their discretion. Putting aside *Daugherty* trust principles, the Legislature and Governor may be able – at least prospectively – to eliminate the independence of these boards and their funds entirely by placing their funding fully within the General Fund. If the Legislature has that power, it would certainly seem to have the lesser power to use Proposition 13's 2/3 vote requirement to transform some of the money in the special funds to general use taxes.

4. <u>Are the loans fair to licensees and consumers even if approved by 2/3 of the Legislature?</u>

However, calling these transactions "loans" and including them in the Budget Act without prior warning to the boards, and without divulging the fact that under state statute it is possible that they will never be repaid, practically deprives licensees or consumers from lodging their arguments against what are, in effect, new taxes imposed upon licensees; taxes imposed in such a round-about way that they might also jeopardize the health and welfare of California patients and consumers.

This "fairness" point would exist even if Proposition 13 had never been enacted. But because a minority of elected legislators can defeat new taxes under our constitution, the consequence of not calling a tax a tax is even more significant for those licensees and consumers affected, since it is relatively easy to defeat a tax when it is actually called one.

The equities are particularly forceful when one considers a licensee who will retire at the end of 2005 who has for two budget years seen a portion of her licensee fee used to fund the General Fund deficit. How will the benefit of repayment reach her after her retirement? If her professional board is repaid after her retirement, it is likely the board would spend the money on filling the empty chairs and cubicles that likely caused the borrowed-from board surplus in the first place, thus bringing the board's program just up to where it was before 2002. Or, if her board decides that its is adequately staffed, the likelihood is that the board (comprised mostly of currently practicing licensees) would order a prospective reduction in fees.

From the perspective of our hypothetical retiree, absent an unlikely future repayment that makes her whole, there is only one word that fairly describes whatever portion of her fees were "loaned" to fund the ongoing deficit – tax.

VI. Conclusion: Taxes Or Loans; The Proof Is In Repayment.

The budget staff who were so helpful in guiding Committee staff through the details of these loans were consistent in expressing their belief that, in fact, the loans would be repaid entirely in good faith. If repayment to the boards is made when the board-lender believes the money is needed, ***and*** if "need" is interpreted by the borrower and lender as embracing what ***the board in its judgment*** believes is needed to obey the full letter and full spirit of a board's statute-imposed, consumer-protection charge, as opposed to just avoiding insolvency, then deeds will prevail over form, and the "loans" will actually operate like real and entirely lawful loans, our hypothetically retired licensee notwithstanding.

However, the record does not yet support this view. The record so far reveals year-after-year after-the-fact borrowing with little or no notice, no permission, and no negotiation, from surpluses in part created by a prior hiring freeze or current hiring limitations imposed by the borrower; nebulous terms and timetables for repayment; and the practical inability of boards under the power of their borrower to demand repayment when they – not the borrower – think they need it to meet their legal obligations in an effective way. It is difficult to see how such borrowing purely on its face could easily satisfy either *Sinclair* or *Daugherty*.

Beyond the legalities, the raw fact remains that the boards consulted for this paper are not forecasting any repayment of these loans in the near or mid-term, nor do they candidly expect to be repaid any time soon, let alone with interest.

Hence, until the time that these "loans" fit the definition of that word in practice, they are currently better described by another word: taxes.

There may or may not be anything at all wrong with the imposition of taxes on licensees and not other Californians to address the state's budget woes. But calling them something else prevents just such a debate, and both the licensees who pay what they think are fees and the consumers whose lives may depend upon them being spent for the purposes for which they were paid, have a stake in that debate; maybe not a persuasive or prevailing stake, given competing priorities, but a stake nevertheless.